INDEX

	Page
Opinions Below	2
Jurisdiction	2
Question Presented	2
Statute Involved	2
Statement	3
Reasons For Granting The Writ	4
Conclusion	9

Appendix A 1a

TABLE OF CITATIONS

CASES:

Area Rate Proceeding (Permian Basin Area) 34 FPC ——, Opinion No. 468 (1965)	6
Cities Service Gas Co. v. Federal Power Commission (CA 10, 1946) 155 F. 2d 694, cert. den. 329 U.S. 773, rehearing denied, 329 U.S. 832	5
Colorado Interstate Gas Co. v. Federal Power Commission, 324 U.S. 581	6
Federal Power Commission v. Hope Natural Gas Company, 320 U.S. 591	5
Federal Power Commission v. Natural Gas Pipe Line Company, 315 U.S. 575	6
Mississippi River Fuel Corp. v. Federal Power Commission, 252 F. 2d 619 (CADC 1957)	8
Phillips Petroleum Co., 24 FPC 537 (1960), affirmed *sub. nom.* Wisconsin v. FPC, 303 F. 2d 830 (1961), affirmed 373 U.S. 294 (1963)	6
Union Producing Company, 31 FPC 41 (1964)	8
Willmut Gas and Oil Co. v. Federal Power Commission, 299 F. 2d 111 (CADC 1962)	8

Statutes and Regulations:	Page
Federal Tax Regulations, 1965, Vol. 1, Sec. 1.1502-31	8
Internal Revenue Code, 26 USC 1552	7
SEC Holding Company Act Regulations, Sec. 250.45 (b)(6)	7

Legislative Materials:

Hearings before the Committee on Finance, United States Senate, Eighty-Ninth Congress, First Session, on Senate Amendment 426 to H.R. 7502 (1965), pp. 231-2	7

IN THE

Supreme Court of the United States

OCTOBER TERM, 1965

No.

MEMPHIS LIGHT, GAS AND WATER DIVISION, *Petitioner,*

v.

UNITED GAS PIPE LINE COMPANY, NATURAL GAS PIPE LINE COMPANY OF AMERICA, and TEXAS EASTERN TRANSMISSION CORPORATION

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

To the Honorable the Chief Justice and Associate Justices of the Supreme Court of the United States:

Petitioner, Memphis Light, Gas and Water Division ("Memphis Division"), respectfully prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit entered on February 10, 1966.

OPINIONS BELOW

The opinion of the Court of Appeals for the Fifth Circuit is not yet reported. It is printed as Appendix A to the Federal Power Commission's petition for a writ of certiorari to review the same judgment. The opinions and orders of the Federal Power Commission are reported in 31 FPC 1180, the relevant portions of which are pages 1190 and 1191, 32 FPC 687, 879, and 1163. The record has been filed in support of the FPC Petition for Certiorari.

JURISDICTION

The mandate of the Court of Appeals for the Fifth Circuit was issued on March 7, 1966 (FPC Pet. for Cert., App. B). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

QUESTION PRESENTED

Whether, in fixing rates of a natural gas company, the Federal Power Commission must allow as part of the utility's cost of service the amount of federal income taxes it would have paid if it had filed a separate tax return, when in fact it filed a consolidated return with affiliated corporations, resulting in an overall tax saving for the group of affiliates.

STATUTE INVOLVED

The pertinent provisions of the Natural Gas Act, 52 Stat. 821-833, as amended, 15 U.S.C. 717-717w, and of the Internal Revenue Code of 1954, 68A Stat. 3, et seq., as amended, 26 U.S.C. 1-8023, are set out in the FPC Petition for Certiorari.

STATEMENT

Memphis Light, Gas and Water Division is a division and wholly-owned agency of the City of Memphis, Tennessee. Among others things, Memphis Division owns and operates a gas distribution system for the distribution and sale of natural gas throughout the City of Memphis and in Shelby County, Tennessee, to residential, commercial, and industrial consumers.

To meet the gas needs of these consumers, Memphis Division purchases natural gas from Texas Gas Transmission Corporation ("Texas Gas"), an interstate natural gas pipeline company, which, in turn, obtains substantial volumes of natural gas from United Gas Pipe Line Company ("United").

The most important and largest item affecting rates charged by Texas Gas to Memphis Division is the cost of gas purchased by Texas Gas from United and other sources. The cost of gas purchased by Memphis Division from Texas Gas is also the largest and most important element in the rates Memphis Division charges the ultimate consumers.

In the rate proceedings before the Federal Power Commission on United's proposals to increase its rates to Texas Gas and others, Memphis Division was permitted full intervention as a party and actively participated in the proceedings. In the court below, Memphis Division was also granted intervention; it filed a brief and participated in the oral argument in support of the Commission's orders.

Memphis Division adopts, without repetition, the "Statement" of the Federal Power Commission's petition for a writ of certiorari in which the proceedings before the Commission, United's operating and tax

filing practices, the Commission's findings as they relate to the question presented, and the decision of the court below are detailed.

REASONS FOR GRANTING THE WRIT

The importance of a definitive determination of the question presented is well-covered in the Federal Power Commission's petition for a writ of certiorari. Memphis Division adopts the reasons for granting the writ advanced by the Commission in its petition.

1. The decision of the court below will require the Commission to allow, and the consumers to pay, in rates an amount for federal income taxes in excess of the public utility's federal income tax liability, and thus, in effect, subsidize non-utility operations. For the Commission, under that decision, must ignore applicable cost allocation procedures and arbitrarily compute the public utility's income tax allowance on the fiction that the public utility files a separate tax return, although, in fact, it files no separate return but through participation in a consolidated tax return experiences a smaller tax liability due to recurring tax losses of an affiliated gas producer whose operations are an integral part of the public utility system.

The result of the decision of the court below will be to increase the cost of gas to over 100,000 gas consumers served by Memphis Division. The decision will also adversely affect the cost of gas to millions of gas consumers throughout the country who purchase gas sold by the 39 natural gas pipeline companies that participate in consolidated tax returns (FPC Petition for Certiorari, p. 15).

The effect of the Fifth Circuit's decision is not only far reaching in terms of the number of consumers that

will be adversely affected thereby, but it is also far reaching in the effect on "the primary aim" of the Natural Gas Act "to protect consumers against exploitation at the hands of the natural gas companies", *Federal Power Commission* v. *Hope Natural Gas Company*, 320 U.S. 591, 610. The decision can only impede the Commission's administration of the Act to attain its objective.

2. Memphis Division readily agrees that consumers should pay every legitimate and reasonable cost actually incurred by the natural gas pipeline companies and their gas producing affiliates in rendering natural gas service, but Memphis Division submits that it is neither appropriate nor necessary nor lawful to require consumers to pay amounts which exceed the actual costs for federal income taxes or any other component of cost of service, and thereby allow the utility to earn excessive returns at the expense of the consumers.

A utility is not entitled to have included as an expense in cost of service an amount which will not be incurred. *Cities Service Gas Company* v. *Federal Power Commission* (CA 10, 1946) 155 F. 2d 694, 704, *certiorari* denied, 329 U.S. 773, rehearing denied, 329 U.S. 832. This rule is just as applicable where the cost incurred applies to more than one class of business, i.e., regulated or jurisdictional and non-regulated or non-jurisdictional, and is, therefore, a joint cost.

The application of the rule is merely more complex and more dependent on informed judgment and expertise where joint costs are involved, because an allocation is required to ascertain the utility's cost and to assign to each class of business only a fair share of the total joint cost actually incurred. Since United

participated in a consolidated tax return, allocation was required to determine United's tax cost that should be included in its cost of service and borne by the consumers.

Congress has prescribed no allocation formula which the Commission must use. *Colorado Interstate Gas Co.* v. *Federal Power Commission,* 324 U.S. 581, 589 (1945). The choice of the formula or method of allocation is for the Commission (*Ibid.*). The appropriateness of the formula raises questions of fact, not of law (*Colorado Interstate* case, *supra,* at page 590), and involves the exercise of informed judgment and discretion by those whose duty it is to make the "pragmatic adjustments . . . called for by particular circumstances." *Federal Power Commission* v. *Natural Gas Pipe Line Company;* 315 U.S. 575, 586. The courts are not warranted in rejecting the method selected by the Commission "unless it plainly contravenes the statutory scheme of regulation." *Colorado Interstate* case, *supra,* at page 589.

The Commission's regulatory responsibilities necessitate virtually constant use of joint cost allocation techniques in maintaining the jurisdictional limits fixed by Congress. For example, when oil and jurisdictional gas are produced jointly, more economically, as a rule, than if they were produced from separate wells, the Commission allocates the joint production cost rather than attributing to jointly produced gas the cost of gas produced as a single product. *Phillips Petroleum Co.,* 24 FPC 537, at pp. 553 et seq. (1960) affirmed *sub nom. Wisconsin* v. *FPC,* 303 F. 2d 830 (1961), affirmed 373 U.S. 294 (1963); *Area Rate Proceeding* (Permian Basin Area) 34 FPC —, Opinion No. 468, mimeo. ed., pp. 83-84 (1965). Such procedure results in the

savings of joint operations being shared between the gas consumers and non-jurisdictional oil business. *Cf.* Letter of Joseph C. Swidler, Chairman, FPC, to Hon. Harry Flood Byrd, Chairman, Committee on Finance, U. S. Senate reported in *Treatment of Tax Benefits Under Consolidated Returns, Hearings Before the Committee on Finance, United States Senate, Eighty-Ninth Congress, First Session, on Senate Amendment 426 to H.R. 7502* (1965), pp. 231-2.

The Commission chose a method of allocation in perfect accord with the actual historical tax practices of United and its affiliates, and the allocation methods prescribed by the Internal Revenue Code for tax purposes and the Securities and Exchange Commission for its regulatory purposes.[1] Under the allocation method selected by the Commission, the participants filing a consolidated tax return are first separated into regulated and non-regulated groups. The net taxable income of each group is next determined. Then, the net total consolidated tax liability for a representative test period is apportioned between the regulated and non-regulated groups, and among the companies in each group having income, on the basis of their respective incomes.

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[1] For tax purposes allocation of the consolidated tax liability is necessary to determine whether dividends paid are out of earnings or capital (26 U.S.C. § 1552). The SEC requires allocation to secure proper financial reporting to investors and the public. *SEC Holding Company Act Regulations,* Section 250.45(b)(6). Appendix A, *infra,* p. 1a. The provisions of the Internal Revenue Code and the Regulations of the SEC for allocation of the consolidated tax liability recognize the joint nature of the cost and require a sharing of the savings produced by the filing of a consolidated return. This procedure is in complete harmony with prevailing business practices.

By this method of allocation the Commission has assiduously respected the limits of its jurisdiction, while at the same time recognizing that the tax saving effected by the use of a consolidated return is for the benefit of all participants. Federal Tax Regulations, 1965, Vol. 1, Sec. 1.1502-31.[2]

The decision of the court below apparently proceeds on the theory that the tax savings effected through use of the consolidated tax return may not be attributed in any part to the regulated business where the tax losses offset against taxable income are associated with unregulated activities. In no other way can the decision of the court below that the "Commission's order was contrary to the requirements which Congress had imposed" be understood. (FPC Petition for Certiorari, Appendix A, p. 18).

Apart from the fact that the regularly recurring tax losses in this case were of a company which is United's "producing arm" (*Union Producing Company,* 31 FPC 41, 43 (1964); *Mississippi River Fuel Corp.* v. *Federal Power Commission,* 252 F. 2d 619, 622-3 (CADC, 1957); *Willmut Gas and Oil Co.* v. *Federal Power Commission,* 299 F. 2d 111 (CADC, 1962) and is subject to the Commission's jurisdiction, the theory disregards the fact that only through the income from the regulated utility operations, secured through rates

[2] In actual fact, the Commission's allocation method is biased in favor of the unregulated business for the tax losses of unregulated companies are first offset against the income of the unregulated group and only tax losses which are not thereby absorbed are offset against income of the regulated companies. Since the value of the recurring tax losses depends upon the existence of the taxable income of the regulated companies, the Commission would have been justified in selecting a method which apportions the total tax losses between regulated and unregulated companies.

paid by consumers, is there assurance that the producing department tax losses can be used to reduce taxes and can be utilized in full.

CONCLUSION

The writ should be granted. The effect of the decision of the court below is of major importance in the administration of the Natural Gas Act, and is in conflict with decisions of this court that leave to the Commission the selection of methods to allocate joint costs. The method selected by the Commission carefully respects the statutory scheme of regulation. The court below has substituted its judgment for the Commission's in a field peculiarly for the Commission's expertise.

Respectfully submitted,

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APPENDIX A

SEC Regulation Section 250.45(b)(6) Promulgated Under the Public Utility Holding Company Act of 1935

"(6) * * * *Provided:* That the consolidated tax liability of the companies joining in such consolidated tax return shall be allocated among the members of the group in accord with either of the methods of allocation prescribed by subparagraphs (a)(1) and (a)(2) of Section 1552 of the Internal Revenue Code of 1954; and *Further Provided:*

(i) That the tax allocated to each subsidiary company shall not exceed the amount of tax of such company based upon a separate return computed as if such company had always filed its tax returns on a separate return basis; and

(ii) That any excess of liability over a separate return tax which would be allocated to a subsidiary company but for subdivision (i) of this subparagraph shall be apportioned among the other members of the group, including the holding company (or other parent company), in direct proportion to the reduction in tax liability resulting to such members as measured by the difference between their tax liabilities computed on a separate return basis and their allocated portion of the consolidated tax liability."